Office of Chief Counsel
Internal Revenue Service

memorandum

CC:[redacted]TL-N-8233-97
[redacted]

date: JAN -6 1999

to: Chief, Examination Division, [redacted] District
Attention: [redacted]

from: District Counsel, [redacted] District, [redacted]

subject: **Request for Advisory Opinion**
[redacted] and Subsidiaries

This responds to your request for advice regarding whether certain interest income received by subsidiaries of [redacted] constitutes interest for purposes of section 543(a)(1) of the Internal Revenue Code[1]. Previously, we provided advice on the question of whether certain rents received by subsidiaries of [redacted] constituted income from rents for purposes of section 543(a)(2). We agreed with Service's position that such income was rent for purposes of section 543(a)(2), providing our opinion in the form of a 10-Day Post Review memorandum, dated December 18, 1997 (TL-N-8233-97). As you know, the National Office thereafter gave us a written response which supported our position.

Although we believe that [redacted]'s position with respect to the disputed interest income would likely be unsuccessful if litigated, we will nonetheless forward our advice to the National Office for review pursuant to the 10-Day Post Review procedures. Under these procedures, we are required to forward a copy of our advice to both the Assistant Chief Counsel (Field Service) and the Northeast Regional Office on this date for post review. Within 10 days after the receipt, the Associate Chief Counsel will respond to our office, indicating whether it: 1) concurs with our advice; 2) believes some modification is appropriate; or 3) needs additional information or time to evaluate our advice. We will advise you of their response as soon as it is received.

[1] All section references are to the Internal Revenue Code as in effect during the years in issue.

Disclosure Statement

This document may contain confidential information subject to the attorney-client and deliberative process privileges, and may also have been prepared in anticipation of litigation. This document should not be disclosed to anyone outside the Service, including the taxpayers involved, and its use within the Service should be limited to those with a need to review the document in relation to the subject matter or case discussed herein. This document also contains tax information of the instant taxpayer which is subject to section 6103.

Issues

1. Whether the certain imputed and "self-charged" interest received by subsidiaries of [redacted] should not be treated as interest income for purposes of section 543(a)(1).

2. Whether certain interest income received by the [redacted] from the lockbox should be recharacterized as [redacted]'s distributive share of ordinary income from the [redacted] partnership.

Conclusion

1. Interest income for purposes of section 543(a)(1) is interest which is includible in gross income under section 61. There is no exception under section 61 excluding the interest which [redacted] alleges to be imputed and self-charged interest. Moreover, [redacted] has, in fact, correctly included such items of interest in its gross income for the years at issue. Finally, [redacted]'s attempt to bootstrap the self-charged interest rules of proposed section 1.469-7 of the regulations into the personal holding company context is contrary to the express dictate of proposed section 1.469-7(a), limiting its application to section 469 only. Thus, the interest at issue is interest income for purposes of section 543(a)(1).

2. For valid business reasons, the [redacted] group chose to establish a lockbox method of banking. Among other things, the lockbox was used to finance the cost of constructing various projects undertaken by the [redacted] partnership. Because the method of financing was based upon a valid business purpose, and was not the result of fraud, duress or undue influence, [redacted] cannot recast the form of the transaction or ignore the existence of the intermediary business entities involved. Thus, the interest income received by [redacted] from the lockbox cannot be recast as [redacted]'s distributive share of ordinary income from the [redacted] partnership.

Law

In addition to the regular corporate income tax, section 541 imposes a tax on corporations that qualify as personal holding companies under section 542. Under section 542(a)(1), C corporations are to be treated as personal holding companies if both of the following occur: 1) 60% or more of the corporation's annual "ordinary gross income" (as adjusted in accordance with the rules under section 543(b)(2)) constitutes "personal holding company income"; and (2) more than 50 percent of the corporation's stock is owned by five or fewer shareholders at any time during the last half of the taxable year. Included in the definition of personal holding company income is rent and interest income. Section 543(a)(1) and (2).

Discussion

Overview The Service has examined [redacted]s consolidated returns for taxable years [redacted] through [redacted] and concluded that it is subject to the personal holding company ("PHC") tax for each of these years. [redacted] is part of a group of business entities owned by the [redacted] family of [redacted] hereinafter collectively referred to as the [redacted] group. The [redacted] group is principally engaged in the ownership and operation of shopping malls, strip centers and plazas. Pages 10 through 27 of [redacted]s protest set forth the history of [redacted] group, tracing its evolution into a complex matrix of interrelated corporations and partnerships. By the [redacted], this growth necessitated the creation of a "lockbox" role for the [redacted] The [redacted] is a wholly-owned subsidiary of one of the major corporate entities in the [redacted] group. [redacted] was selected to perform the lockbox role because it owned no material assets, had no debt and had no "operational liabilities."

As the "lockbox," [redacted] received rents due from the tenants of the various malls, strip centers and plazas of the [redacted] group, which it then deposited into a commercial bank account maintained by [redacted]. According to the examining agent, [redacted] was generally responsible for issuing checks drawn on this lockbox bank account used to pay the operating expenses and other obligations for most of the members of the [redacted] group.

[redacted] was also responsible for keeping track of each member's share of the funds on deposit in the lockbox account. At any given time, some members of the [redacted] group would have a positive balance in this account while others had a deficit. As the member deficits were in essence funded or covered by other members' positive balances, [redacted] allocated interest expense to members with deficits and interest income to members with positive balances. According to the protest, this income or expense was not formally received or paid by a check, but rather, would be realized or paid as the deficit balances were eliminated. Further, there were no formal loan documents between any of the particular members manifesting a debtor-creditor relationship for these offsetting positions, i.e., the deficits which were "covered" by the positive balances. This interest is hereinafter referred to as the covered deficit interest. According to the examining agent, there are approximately [redacted] lockbox depositors, and of which approximately [redacted] have deficit balances in their individual accounts.

The excess of positive balances over deficits in the lockbox was used to pay current operating expenses of the lockbox members, invested with third parties, or formally loaned to members of the [redacted] group. The interest income generated from third-party loans and formal loans to group members was likewise spread among the members with positive balances in the lockbox. The rate of interest used to calculate covered deficit income or expense of the lockbox members was the same interest rate that was realized from the third-party loans and formal loans to group members.

Issue 1 [redacted] contends that the only interest income realized by the lockbox members which should be treated as interest income for purposes of section 543(a)(1) is interest received from third-parties. It contends that covered deficit interest and self -charged[2] interest should not be considered interest income for PHC tax purposes.

Covered Deficit Interest [redacted] first addresses the covered deficit interest, arguing that this interest is merely imputed interest, which although recognized for regular income tax purposes, is never received in an economic sense, but rather is realized only in a bookkeeping sense. [redacted] contends that such interest should be ignored because it is not the kind of income that Congress intended to be included in PHC income. [redacted] argues that the PHC tax regime has not kept pace with the many changes to the regular income tax structure that have occurred since the inception of the PHC tax in [redacted]. [redacted] contends that the static nature of the PHC tax regime, despite the evolutionary regular income tax structure, has "oftentimes created unintended consequences that are quite contrary to the purpose and spirt of the PHC penalty surtax statutory scheme." Protest at page 81. It is [redacted]'s contention that inclusion of imputed interest (and

[2] Self-charged interest, discussed below, is interest received on loans by corporate partners to their partnerships. [redacted] argues that for PHC tax purposes, such interest income should be first offset/eliminated by the resulting related interest expense deduction which flows through to the corporate partner from the partnership.

self- charged interest) in PHC income is one example of an unintended consequence.

We disagree. First, it is factually incorrect to allege that the covered deficit interest is nothing more than a mere bookkeeping entry which is never paid. [redacted] maintains an accounting of each lockbox member's share of the lockbox. Each month, the share for those members with a positive balance in the lockbox increases by, among other things, covered deficit interest. This increased to the member's share of the lockbox definitely is an economic benefit to the lockbox member.

Moreover, there is no question that "imputed" interest is PHC income. Section 543(a)(1) defines personal holding company income, in part, as that portion of the adjusted ordinary gross income which consists of "[d]ividends, interest, royalties * * * and annuities" with certain exceptions not here relevant. Section 1.543-b)(2) of the regulations further defines interest for purposes of section 543(a) as "any amounts, includible in gross income, received for the use of money loaned." In Lake Gerar Development v. Commissioner, 71 T.C. 887, 894 (1979), the Tax Court provided a review of the legislative history of the PHC tax regime from its inception, and concluded that interest for PHC tax purposes has the same meaning as it does for purposes of section 61. In Krueger Co. v. Commissioner, 79 T.C. 65 (1982), the petitioner made interest-free loans to two commonly owned corporations. The Commissioner asserted a section 482 interest income adjustment against the petitioner, reflecting the interest that the Commissioner determined would have been earned by a lender in a similar arms length transaction[3]. The petitioner conceded this adjustment, but challenged the Commissioner's further determination that the interest income allocated to the petitioner pursuant to section 482 made the petitioner subject to the PHC tax for that year. The petitioner contended, as [redacted] does, that the PHC tax was intended by Congress to tax "real, not fictional income." The Tax Court ruled against the petitioner, based upon its holding in Lake Gerar, finding that because the interest at issue therein was interest for purposes of section 61, it was likewise interest for PHC tax purposes.

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[3] Section 1.482-2(a)(1) of the regulations provides:

> Where one member of a group of controlled entities makes a loan * * * to * * * another member of such group, and charges no interest, * * * the * * * [Commissioner] may make appropriate allocations to reflect an arm's length interest rate for the use of such loan or advance.

[redacted] argues that under the case law, one may ignore the plain language of the PHC tax provisions when they lead to a harsh result. [redacted] relies upon the anomalous decision of Rod Warren Ink v. Commissioner, 912 F.2d 325 (9th Cir. 1990), rev'g 92 T.C. 995 (1989), as supporting authority. In that case, the issue was whether, for PHC tax purposes (even though not permitted for regular income tax purposes), a taxpayer could carryback a theft loss from the year of discovery to the year of the theft. The 9th Circuit reversed the Tax Court's holding in favor of the Commissioner, despite the plain language of the statute and legislative history to the contrary. [redacted]'s discussion of the Rod Warren decision fails to note that the Commissioner issued a nonacquiesence with respect to the 9th Circuit's opinion, finding in part, that the Rod Warren decision lacked "sound analytical foundation." AOD 1991-16 (July 03, 1991). The rationale of the Rod Warren decision clearly does not comport with the body of case law of this question. To the contrary, as stated in Kurt Frings Agency, Inc. v. Commissioner, 42 T. C. 472 (1964) "If petitioner meets the literal definition of a personal holding company, then the provisions of section 541 apply." The detail and strictness of the personal holding company provisions have resulted in hardship and apparent inequity in several situations, but relief of hardship requires legislative, not judicial, correction. St. Louis Company v. United States, 237 F.2d 151, 158 (C.A. 3rd 1956).

[redacted] also relies heavily upon Knight Newspaper, Inc. v. Commissioner, 143 F.2d 1007 (6th Cir. 1944), as does the Rod Warren decision. In Knight, a personal holding company received, in 1939, a large dividend on common stock declared by its subsidiary. In 1940, this dividend was rescinded because state law and the terms of the subsidiary's preferred shares forbade payment of a dividend under the subsidiary's existing financial condition. As payment had been constructively effected by a credit of the amount on the subsidiary's indebtedness account with the parent taxpayer, refund was made by a canceling debit entry in 1940. In holding that the dividend should not be included in the parent's undistributed PHC income in 1939, the court reasoned that, as the dividend had originally been declared under a mistake of fact which was recognized and corrected with the concurrence of all parties concerned, equity impressed upon the amount so received a constructive trust and the parent held it as trustee.

[redacted]'s discussion of Knight fails to note that in a subsequent opinion by the same court, the Knight case was limited strictly to its facts. See Haberkorn v. United States, 173 F.2d 587, 590 (6th Cir. 1949). The Knight case has also met with disapproval. St. Regis Paper Co. v. Higgins, 157 F.2d 884, 885, (2d Cir. 1946) cert. denied 330 U. S. 843. Apart from this, the facts upon which the Knight decision was based are easily distinguished. In Knight, unlike the present case, the taxpayer had no accumulation of income and thus no income to distribute. There is no question that the interest income generated to the lockbox members was taxable income.

Self-Charged Interest [redacted]'s argument, set forth at pages 93 through 96 of the protest, seeks to eliminate all "self-charged" interest, as defined under proposed section 1.469-7 of the regulations, from the computation of PHC income. The self-charged rules are designed to address the inconsistency that arises when a member of a passthrough entity receives a distributive share of interest income on debt of the passthrough entity (partnerships as well as subchapter S corporations). When a partner makes a loan to a partnership for use in an activity subject to the passive loss limitations of section 469, the interest payments the partner receives are treated as portfolio income (i.e., a positive income source not derived from a passive activity) under the general passive activity rules. Section 469(e)(1). However, the partner's distributive share of the partnership's interest deduction will generally be a passive activity deduction if the activity is a rental activity or if the partner does not materially participate in the activity or is a limited partner. Section 469(c)(1), (c)(2) and (h)(2). Thus, the passive activity deduction does not offset the portfolio income although the economic substance of the transaction is that the partner paid and received the interest. Under the self-charged interest regulations, the portfolio interest income is treated as passive, thereby triggering the offsetting deduction of the passive interest expense passed through to the partner.

Unfortunately for [redacted], however, as Lucy Clarke, Passive Activity Loss Specialist, MSSP, has previously advised[4], the self-charged interest rules of proposed section 1.469-7 of the regulations simply do not apply in the context of the PHC tax rules. We agree with Ms. Clark. Moreover, the essence of [redacted]'s theory, i.e., interest income should be first reduced by any related interest expense which may have generated the interest income before including it in PHC income, has been rejected by Hildun v. Commissioner, T.C. Memo. 1967-210, aff'd 408 F.2d 1117 (2d Cir. 1965). In that case, a finance company argued that its interest income should be reduced by interest which it paid to banks for the use of money it borrowed to use in its financing operations. The taxpayer's rationale submits that it was in the business of merchandising money, and that interest paid out to obtain this merchandise should be considered as part of its cost of

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[4] A copy of Ms. Clark's advisory opinion concerning this particular question is attached hereto.

goods sold, to be deducted from the gross sales revenue, i.e., interest income, as is the case of any other mercantile business.

The court rejected this theory and held that: 1) unlike a mercantile business, the taxpayer was in fact not engaged in the sale of goods; and 2) interest expense in this context is not considered in arriving at the amount of gross income from interest, i.e., interest income for purposes of section 542(a)(1), but rather is merely a deduction taken from gross income to arrive at taxable income. The court then ruled that interest income was not to be reduced by interest expense which generated the income.

Issue 2 [redacted] owns [redacted]% of the outstanding stock of [redacted], a C corporation. [redacted] is the majority partner in the [redacted]. [redacted] in turn, is a partner in the [redacted].

[redacted] was created in [redacted] by the merger of [redacted] other partnerships in the [redacted] group. Before the merger, each partnership had identical ownership and ownership percentages, and such ownership and ownership percentages were carried through to [redacted]. The protest, however, does not state specifically that [redacted] was a partner in these [redacted] partnerships. Rather, it seems to suggest that [redacted] became a partner in [redacted] via a "cash contribution.[5]"

The protest indicates that [redacted] was created to construct and operate a mall and [redacted] strip centers on the [redacted]. [redacted], however, did not obtain third-party financing for these projects. Rather, the funds needed for these projects were obtained by [redacted] from the lockbox. The protest seems to suggest that funds to finance these projects were accounted for as increases to [redacted]'s deficit in the lockbox account, and we will thus assume so for purposes of this issue.

[redacted] argues that the covered deficit interest income received by [redacted] from the lockbox, which it, in turn, passed through to [redacted], should not be considered interest income for PHC tax purposes. [redacted] contends that during the years in issue, [redacted] maintained substantial surpluses in the lockbox, i.e., between approximately $[redacted] to $[redacted], while at the same time, [redacted] had lockbox deficits of between approximately $[redacted] to $[redacted]. [redacted] contends that [redacted]

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[5] According to the protest, although [redacted] was required under the [redacted] partnership agreement to make a de minimis initial capital contribution of $[redacted], it, in fact, did not do so.

[redacted]'s deficits were in essence being financed by [redacted]'s surpluses, which thus amounted to loans by [redacted] to [redacted]. However, continues [redacted], these "alleged loans" by [redacted] should be recast, under the principles of debt versus equity, into capital contributions by [redacted] to the [redacted] partnership. [redacted] argues that if [redacted]'s covered deficits are recast as capital contributions, then the covered deficit interest received by [redacted] from the lockbox would likewise be recast as payments from [redacted].

We believe that [redacted]'s theory for recasting the lockbox interest in the manner summarized above has little chance of success. There are at least two major obstacles which must be overcome for [redacted] to be successful. First, [redacted] must show that the lockbox should be ignored and the interest expense owed by [redacted] to the lockbox should instead be viewed as flowing directly to [redacted] (and then on to [redacted]). If successful, it must then show that under the principles of debt versus equity, the alleged loans by [redacted] to [redacted] are, in substance, capital contributions to [redacted], and the payments received by [redacted] with respect to these alleged loans should be recast as a [redacted]'s distributive share of the ordinary income of [redacted]. We believe that [redacted] clearly cannot overcome these obstacles.

[redacted]'s protest offers very little analysis to support its conclusion with respect to the first obstacle, i.e, recasting the transaction as direct loan by [redacted] to [redacted]. It cites Van Sickle Development Co. v. Commissioner , T.C. Memo. 1978-161 and Advance Homes, Inc. v. Commissioner, T. C. Memo. 1990-302, as alleged examples of this in the context of the PHC tax. However, in these two cases, unlike the present case, the Commissioner was seeking to impose the PHC tax on the intermediary entity ([redacted]'s equivalent), and not the parties who actually invested the funds with the intermediary ([redacted]'s equivalent). The Tax Court held in favor of the taxpayer in these cases, finding that the intermediary was, in essence, an agent or conduit for interest income which it was passing on to other entities. In the present case, Exam is seeking to impose the PHC tax on [redacted], the ultimate recipient of the interest income which it receives from [redacted], which it, in turn, receives from [redacted]. Exam is not asserting the PHC tax against [redacted].

The dispositive question with respect to this first element is whether [redacted] can recast the form of the transaction at issue. We believe that the answer to this is clearly "no." The interest allocated among the lockbox members was "real" for both economic and tax purposes. Moreover, the lockbox was established for a clearly valid business purpose. There were over [redacted] depositors who participated in the lockbox, [redacted] of which had deficit balances. Given this, it is unreasonable to argue that [redacted] should be recast as the creditor of [redacted], when in reality, there are many lockbox members whose account surpluses fund [redacted]'s [redacted]'s funding needs.

In addition to recasting the transaction, it could also be argued that [redacted]'s position improperly ignores the separate corporate identity of [redacted]. In Moline Properties, Inc. v. Commissioner, 319 U.S. 436 (1943), the U.S. Supreme Court refused to ignore the corporate form for tax purposes even though the corporation involved was completely dominated by its shareholder and appeared to lack beneficial ownership of its assets and income:

> The doctrine of corporate entity fills a useful purpose in business life. Whether the purpose be to gain an advantage under the law of the state of incorporation or to avoid or to comply with the demands of creditors or to serve the creator's personal or undisclosed convenience, so long as that purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity. * * * In *Burnet v. Commonwealth Improvement Co.*, 287 U.S. 415, * * * [it was held that] The choice of the advantages of incorporation to do business, * * * required the acceptance of the tax disadvantages. 319 U.S. at 438-439. [Fn. refs. omitted.]

We believe that the extensive discussion set forth in the protest regarding how the need for the lockbox arose, and [redacted]'s role with respect to the lockbox function, eliminates any doubt as to whether [redacted] was operated for a valid business purpose. Accordingly, under the rule of Moline, [redacted] cannot be disregarded as urged by [redacted].

Finally, we agree with the examining agent's analysis by which he concludes that if [redacted] were nonetheless successful in recasting the transaction as a loan between [redacted], it is unlikely that it could then successfully recast the resulting debt as a capital contribution to [redacted]. The examining agent's analysis of this question is set forth at pages 5 through 9 of his response to [redacted]'s protest.

If you have any questions regarding the foregoing, please contact Attorney [redacted] at [redacted].

[redacted]
District Counsel

By: [redacted]
Senior Attorney

Attachment:
Advisory Opinion from Passive Activity Loss Specialist, MSSP, dated November 25, 1997

INTERNAL REVENUE SERVICE
MEMORANDUM

DATE: Nov. 25, 1997

TO: Joe Fabrizio, RA

FROM: Lucy H. Clark, Passive Loss Issue Specialist, MSSP
IRS:PAL, 195 Commerce Way-Suite B, Portsmouth, NH 03801
Tel. 603-433-0723

RE: Passive Activity Losses - Self-Charged Interest

QUESTION: Is interest which is recharacterized under Reg. 1.469-7 as self-charged interest excepted from the definition of interest under 543(a)(1) for personal holding companies?

ANSWER: No! Section 469 rules cannot be applied to any other Code section. Reg. 1.469-1T(d) explicitly provides that neither the characterization of income or deductions as passive activity gross income or passive activity deductions affects the treatment of any item of income or gain under any provision of the Internal Revenue Code other than section 469.

There is absolutely no provision in Code section 469 or the regulations or the legislative history which would imply that the self-charged rules in Reg. 1.469-7 should somehow be used to negate the characterization of interest income for purposes of determining whether the activity constitutes a personal holding company. Reg. 1.469-7(a) provides, "This section sets forth rules that apply, for purposes of section 469 and the regulations thereunder ...

The self-charged interest rules in Reg. 1.469-7 were designed to recharacterize interest income as passive income in order to trigger deductibility of interest expense from related party loans to partnerships and S corporations in which the taxpayer is passive. In other words, in order to offset interest income which taxpayer is required to report from loans to related entities , taxpayer may treat self-charged interest income as passive (reflecting it on Form 8582, thereby triggering the same amount of interest expense). See Reg. 1.469-7, PLR 9526001, and TAM 240070-96.

Furthermore, the rules that recharacterize income as passive (Reg. 1.469-7) or nonpassive (Reg. 1.469-2(f)(6), 1.469-2T(f)(3), etc.) do not change the character of the activity. Income is merely treated as passive or nonpassive for purposes of section 469, the passive loss limitations.

Lucy H Clark